NATIONAL FORECAST DESCRIPTION
The Forecast Period is the Second Quarter of 2000 to the Fourth Quarter of 2003

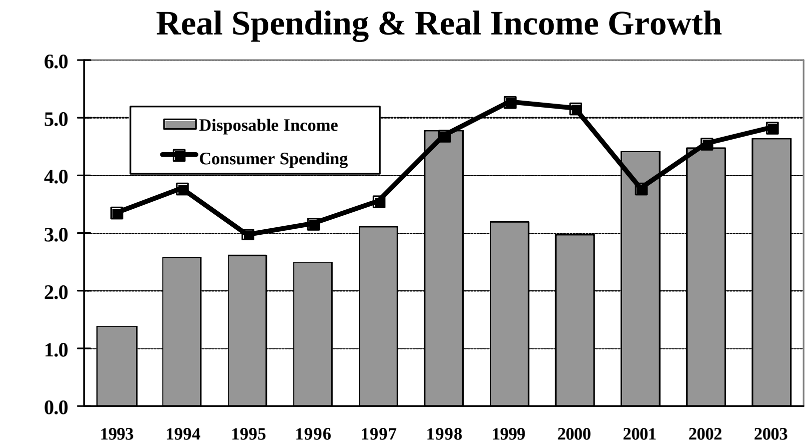
Recent evidence suggests that the U.S. economy is enjoying robust health as the ongoing expansion closes in on its tenth anniversary. Real GDP increased at a 5.6% annual rate in the second quarter of 2000. On an annual basis, it is projected that real GDP will advance 5.2% for all of 2000—its best showing since 1984. It will also be the fourth straight year real economic output rose by at least 4.0%. The strong economy has stretched the labor pool to its limits. The national civilian employment rate has fallen from 7.5% in 1992 to around 4.0% currently, and the economy has been at or above full employment since 1997. Despite the tightest labor market in decades, inflation has been tame. Usually, wages rise in tight labor markets, eventually causing overall prices to heat up. There are several reasons why this has not happened. First, health care benefits have not taken off as expected. This is because employers moved from traditional health providers to lower-cost health maintenance organizations and preferred-provider options. Second, because of the low inflation, workers' wages go further, keeping wage inflation from taking off. Third, huge productivity gains have helped keep production costs down.

Of course, the economy cannot continue at this torrid pace without running out of labor. This would create imbalances that would threaten further growth. The Federal Reserve is keenly aware of this and has raised interest rates six times, by a total of 175 basis points, in order to head off inflation. Currently, it is unclear how much effect this policy has had. Real GDP grew strongly during the first half of this year, but showed some signs of slowing in the third quarter. Housing weakened earlier this year, but began to recover as mortgage interest rates dropped this summer. It is likely the Federal Reserve is done tightening for this year. The central bank realizes it takes about one year to see the effects of its actions, so it is waiting to see how effective its policy has been. Second, the strong economy and low inflation has provided a larger margin of error than the Federal Reserve usually has to work with, providing more room to recover from policy errors. Third, the Federal Reserve is usually reluctant to make any policy changes this close to a presidential election.

This does not imply smooth sailing for the Federal Reserve; the future will have its share of challenges. Perhaps the biggest is the increased uncertainty in which it will have to set policy. The problem is recent experience has changed the rules. Previously, it was felt the economy could grow between 2.5% and 3.0% without creating any imbalances. As pointed out above, it has grown by over 4.0% since 1997 without creating any problems. Thus, it is logical to assume there is more headroom in the economy, but it is not clear how much. Most current estimates assume potential real GDP growth is between 3.5% and 4.0%. This is a significant increase. While this may be a small, absolute change in the growth rate, it is a huge difference in the speed of growth. For example, the difference between 3.5% and 2.5% is just 100 basis points. However, at 3.5%, real GDP is growing 40.0% faster than at 2.5%. The Federal Reserve now finds itself looking at a pegged speedometer while attempting to determine a safe speed for the economy. Deciding when to hit the brakes is a little more challenging.

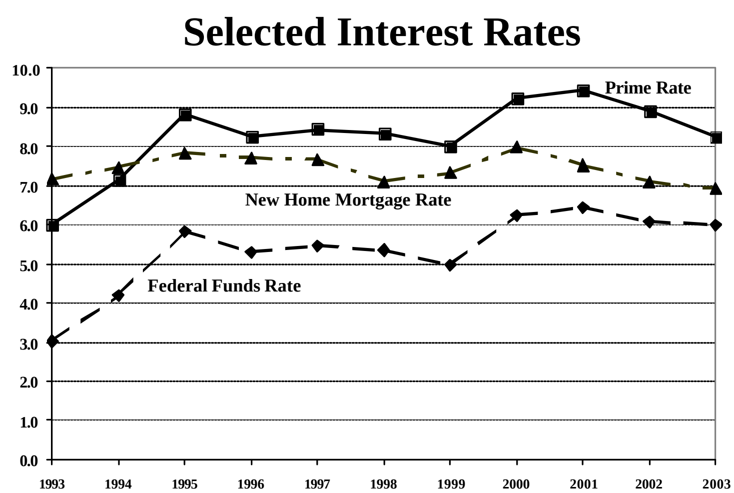
Overall, the U.S. economy shows few signs of the imbalances that would end this expansion. The current forecast calls for continuing growth, but at a slower pace, for the next few years. Eventually, an outside shock or policy mistake will cause a recession, but this triggering event has not yet occurred.

SELECTED NATIONAL ECONOMIC INDICATORS



Source: Standard and Poor's DRI

Consumer Spending: A look at several factors suggests the "best of times" consumers have enjoyed over the last few years are over. Still, the next few years promise to be "pretty good times." Real consumer spending growth is expected to slow over the forecast period, but not as much as current conditions would usually indicate. A surging stock market, low energy prices, a strong job market, and low interest rates combined to lift consumer confidence. Acting on their increased sense of economic well-being, consumers went on a spending spree where spending easily rose faster than disposable income. Consumers remain remarkably upbeat despite a cooling in the factors that have brought about recent prosperity. These factors include slower income growth, a flat stock market, and rising gasoline prices. The latter has touched the most Americans. As a result, consumers bought 1.5% less gasoline in the first half of this year than in the same period of 1999. However, because of higher prices, they actually spent about $40 billion more for this reduced amount compared to last year. Surveys show consumers view the surge in gasoline prices to be temporary, so increases have not eroded confidence significantly. However, prolonged increases could sour consumers' dispositions, turning consumer confidence south. <u>Real consumer spending is forecast to rise 5.2% this year, 3.8% next year, 4.6% in 2002, and 4.8% in 2003.</u> In order to finance spending, consumers have increasingly turned to credit and savings. As a result, over the past two years, non-mortgage consumer credit has increased from 20% to 21% of disposable income. This is up from around 18% as recently as 1998. The decline in the savings rate is even more drastic. The personal savings rate dipped into negative territory in July 2000, hitting an all-time low of -0.2%. This begs the question: Why is savings so low? The answer is Americans have become wealthier over the past few years. In fact, rising stock prices has sent wealth to record levels. The average U.S. household now has an average net worth of $360,000. This is more than six times average household earnings. The bottom line is the stock market has been doing the saving for Americans. Recent research supports the conclusion that rising wealth has caused the savings rate to ebb. However, the exact relationship between wealth and savings has yet to be quantified.

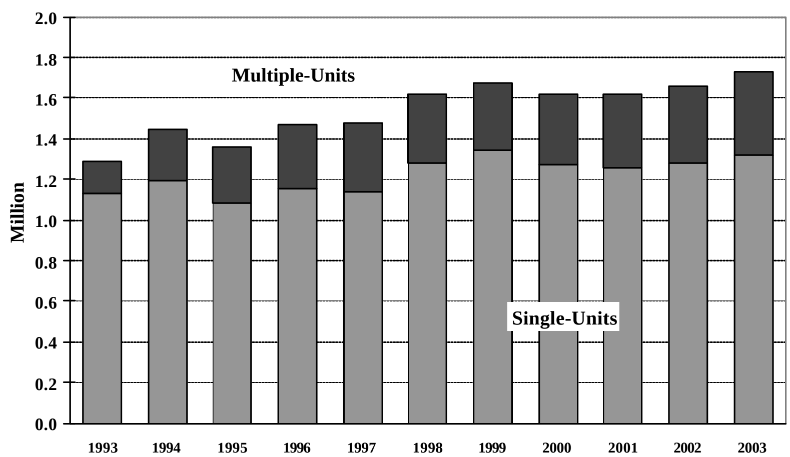


Source: Standard and Poor's DRI

Financial: The Federal Reserve passed on its most-recent chance to raise interest rates during its October 3, 2000 meeting. This sets the tone for the near future; the nation's central bank is not expected to raise its bellwether federal funds rate this year. Instead, the Federal Reserve will probably wait and see if the economy downshifts in the second half of this year. Some signs are already visible. The federal funds rate is currently 175 basis points above last spring's low of 4.75%. Since it usually takes 12 to 18 months to feel the impact of a Federal Reserve policy action, the recent weaknesses in housing and employment suggest past interest rate increases are having their intended results. There are several other reasons why the Federal Reserve is not likely to increase rates soon. First, despite the recent run-up in energy prices, inflation remains low. Thus, it is hard to justify a rate increase based on inflation. The low inflation also contributes to the second reason for the outlook of stable interest rates. Nominal interest rates are fairly low, but real short-term interest rates are high. The last time real interest rates were this high was in 1989. Third, the Federal Reserve traditionally avoids taking policy actions this close to a presidential election. Not only is the Federal Reserve likely to avoid further tightening; there is a high probability that its next move will be to lower rates. However, such a move is not expected until the middle of next year, as the Federal Reserve will not loosen until it is comfortable that there is no need to tighten further. It wants to avoid bouncing back and forth between tightening and loosening because this confuses markets. Should all go as planned, the nation's central bank should successfully execute an unprecedented second soft landing during this expansion. Factors favoring this outcome include the extra altitude provided by the high-flying economy, the lack of inflation turbulence, and good visibility with few obstacles in sight.

Housing: The U.S. housing market has been remarkably resilient in the face of higher mortgage rates and rising housing prices. Housing is the least affordable it has been since 1992. Perhaps the reason the housing sector has not seen a significant decline is because, even at recent peak, mortgage interest rates were relatively low. At its summit of 8.64% in this year's second quarter, the conventional 30-year commitment rate compared favorably with the 9.25% rate recorded during the previous monetary tightening episode in 1994. Another reason is home buyers know they can refinance once mortgage rates retreat, and fear that the price of a house will only rise further if they delay purchase. Recently, mortgage rates have slipped back below 8.0%, which should help stabilize the market. Indeed, the proportion of individuals believing this is a good time to buy a house has been rising. The housing market is just one of the beneficiaries of the federal government surplus. The gradual shrinkage of the supply of long-dated Treasury securities has pushed investors in need of highly liquid, low risk securities to issues of Fannie Mae and Freddie Mac. Both institutions have responded by announcing auction calendars for benchmark issues of plain vanilla coupon bonds with standard maturities. For these issues to have sufficient volume, Fannie and Freddie will have to hold a larger volume of mortgages than before. That probably means they will try to extend more mortgages. Thus, there will be no shortage of funds flowing into the mortgage market. In fact, competition between the two to become the more recognized provider of benchmarks should boost the volume of affordable funds. Single–family housing starts are expected to decline modestly in 2001, but then turn back up as the Federal Reserve starts to lower interest rate towards the end of next year. The availability of mortgage money, the ongoing demand for second homes, and the shortage of houses in some high-growth regions should prevent a more severe downturn. <u>Specifically, total U.S. housing starts are expected to be 1.62 million units in 2000, 1.62 million units in 2001, 1.66 million units in 2002, and 1.73 million units in 2003.</u>

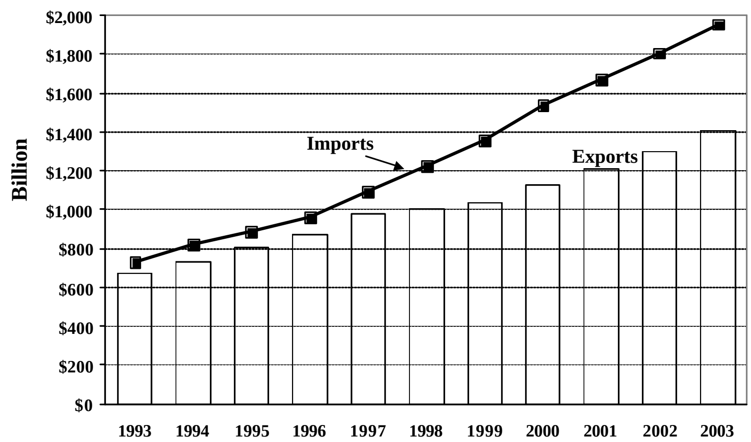
U.S. Housing Starts



Source: Standard and Poor's DRI

International: The current-account trade deficit is projected to deteriorate over the forecast period. This outlook reflects two fundamental factors: the growth of the U.S. economy relative to the other economies of the world, and exchange rates. Both have contributed to the current account ballooning from under $50 billion in 1992 to over an estimated $430 billion in 2000. For most of this period, the U.S. economy has grown faster than those of other industrialized countries. The stronger domestic market has been very attractive to imports. The strong dollar has also tipped the trade balance in favor of exports. In order for exports to recover, and the current-account deficit to shrink, the economies of America's trade partners need to pick up significant speed. Unfortunately, this seems unlikely. For example, Japan's economy has not yet commenced a sustained recovery from its current economic doldrums. Data from the first half of the year show some positive momentum from repeated bouts of fiscal stimulus and encouraging fundamentals in the electronics, transport, and communications sectors. Nonetheless, Japan's recovery hinges on a rejuvenation of the consumer sector, which has not demonstrated a convincing rebound so far. This seems unlikely because income increases are likely to be weighed down by the corporate efforts to streamline jobs and reduce payrolls. Other factors also point to Japan's economy languishing. They include its huge fiscal overhang, residual overcapacity in manufacturing, unfavorable demographics, and an uncompetitive services sector. The strong dollar also presents a challenge for future export growth. After recovering in June 2000, the euro continued to slump in early September to nearly 20% below its level one year ago and about 25% below its early 1999 peak. At the request of the European Central Bank, the G-7 nations intervened to halt the euro's tailspin. This coordinated effort prompted a significant rally that boosted the euro's value to about $0.90. It has since settled slightly below that level. The current forecast assumes the spread between U.S. and EU interest rates will narrow, due to tightening by the European Central Bank. This should put legs under the battered European currency, and help regain the ground lost this summer. The euro should trade at near parity with the dollar next spring, as the European Central Bank out-tightens the Federal Reserve. <u>The U.S. current-account deficit is forecast to be $434.4 billion in 2000, $474.0 billion in 2001, $528.0 billion in 2002, and $583.7 billion in 2003.</u>

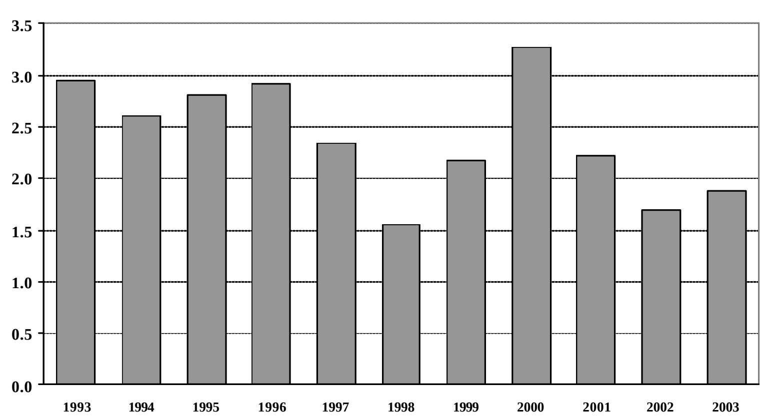
Real U.S. Imports and Exports



Source: Standard & Poor's DRI

Inflation: Two years of gradually accelerating inflation should come to an end late this year, as energy prices peak and then began to moderate. Over the last couple of years, consumer price inflation has risen from 1.6% to 3.3%. The acceleration has come almost entirely from energy; excluding food and energy, inflation has held between 2.0% and 2.5%. So far, there is no evidence the large energy price increases are filtering through to other parts of the economy. Core inflation has remained tame because supply has been able to

Consumer Price Inflation

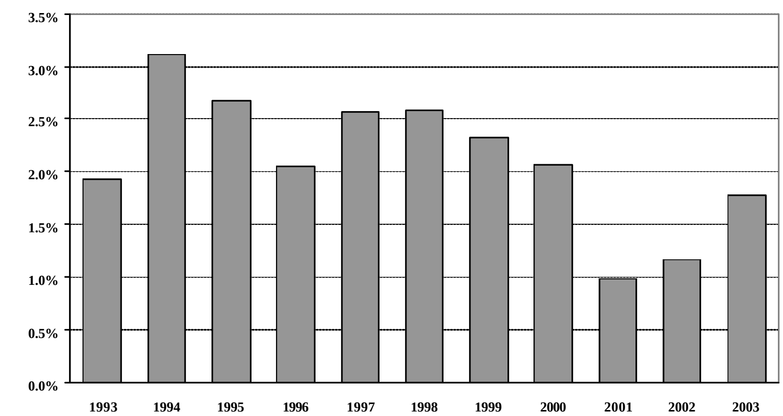


Source: Standard and Poor's DRI

keep up with the rising demand. Prices have been held in check thanks to the near-stability of non-energy commodity prices. This stability has largely offset the large price increases for pharmaceuticals and tobacco products. Of course, there are exceptions to the rule. Most notably, housing and medical care costs have been rising relatively rapidly. The jump in housing prices reflects a shortage of homes in the nation’s hottest real estate markets. After falling below 3.0% in 1997, inflation in medical services is currently running around 5.0%. The slowing economy should provide some relief from inflation next year, but medical care costs should continue to outpace the overall consumer price index, as consumers demand greater choices of doctors and treatments. The one threat that has failed to fan inflationary embers has been wages. This is an especially serious concern given the current tight labor market. As the labor market has tightened, wage increases have indeed accelerated, from about 3.0% five years ago to 4.5% currently. However, the impacts of these increases have largely been offset by rising productivity. In the near future, productivity is expected to continue to defuse wage-related inflationary pressures. Wages are expected to rise 4%-5% annually. Over the same period, productivity gains should fluctuate in the 3%-4% range. Thus, the projected wage increases can easily be accommodated within the anticipated core inflation of 2.0%-2.5% for the next few years. <u>Overall consumer inflation is forecast to be 3.3% this year, 2.2% next year, 1.7% in 2002, and 1.9% in 2003.</u>

Employment: The white-hot employment picture has been cooling lately. The U.S. Bureau of Labor Statistics reported that total nonfarm employment declined in both July and August. While the 105,000-drop in payrolls was due mainly to reductions in the number of temporary census workers, there has been a marked slowdown in the rate of private nonfarm employment growth. After increasing by 0.2% in June 2000, private nonfarm employment rose by a meager 0.1% in July and was flat in August. Some of this week performance is attributable to the Verizon strike. However, after accounting for the strike, the economy would have added just 102,000 persons to payrolls, which is significantly below the 186,000 average for the first half of 2000. This cooling trend is forecast to continue. The number of nonfarm jobs is expected to increase 135,000 in the last quarter of this year. In 2001, it is anticipated that monthly gains will average a mere 72,000 jobs. As the company pulls out of its soft landing, nonfarm growth should reaccelerate. <u>Specifically, U.S. nonfarm employment is predicted to rise 2.1% in 2000, 1.0% in 2001, 1.2% in 2002, and 1.8% in 2003.</u> Although the job creation pace over the next few years is not anticipated to reach the level it reached during the second half of the 1990s, labor markets are not expected to ease significantly. Indeed, the unemployment should hover near 4.0%—which is well below the estimated unemployment rate that is consistent with full employment.

U.S. Nonfarm Employment Growth



Source: Standard and Poor's DRI